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Ukraine

Dairy and Products Annual

2010

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Report Highlights:

As domestic consumption contracts and export demand weakens, production of dairy products in Ukraine is expected to decrease in 2010-2011. Although there was a modest productivity increase, the number of dairy cows decreased and fluid milk production continued to decline. Russia will remain the prime destination for Ukrainian cheese, but trade will remain limited by technical barriers. Imports of butter and high quality dry dairy products will remain subject to technical barrier restrictions. Ukraine will continue limited exports of dry dairy products onto the world market.

Executive Summary:

Continued cow slaughter in 2009-10 significantly compromised the availability of fluid raw milk supplies. At the same time a drop in consumer demand in 2009-2010 resulted in a general decrease in both consumption and production of dairy products. Ukraine's ability to supply foreign markets was diminished. The only exception was the lucrative Russian market where Ukrainian suppliers face slightly fewer restrictions than other exporting countries.

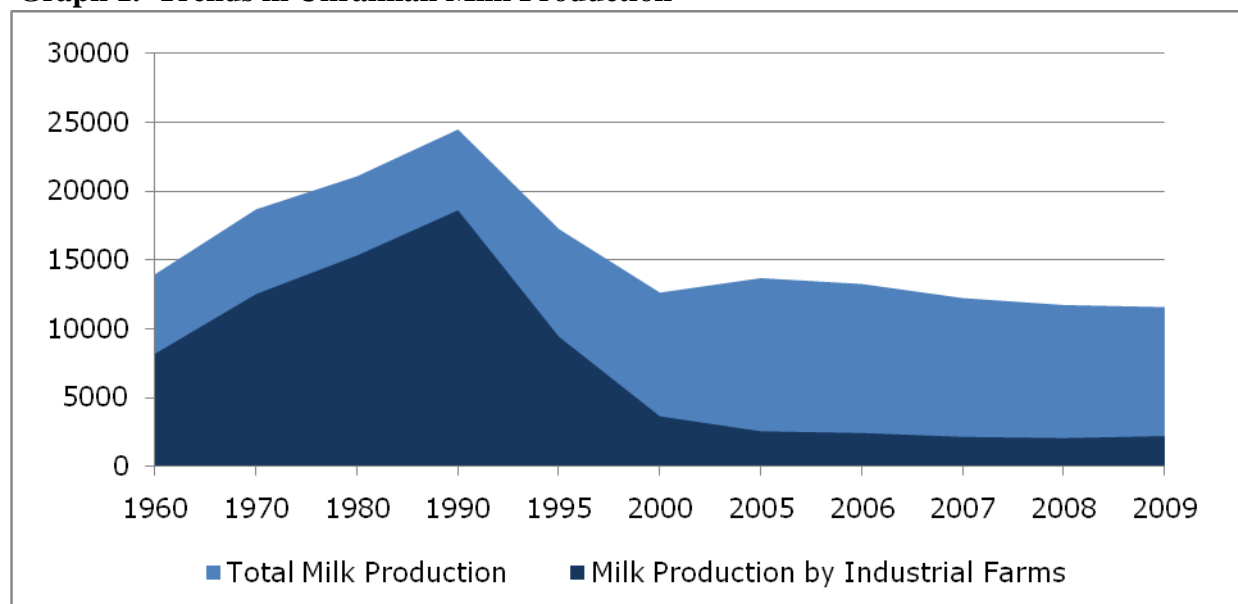
Strong price inflation and the decline in real disposable consumer incomes led to a significant consumption shift toward cheaper products. Consumption of hard cheese was replaced by spread cheese; consumption of yogurts was replaced by cheaper traditional sour milk products. Despite some drop in sales volume the value of all markets (including hard cheese and yogurt) increased.

A significant drop in butter imports in 2010 was caused by new technical barriers to trade rather than by a drop in demand. Butter imports continue to be restricted by the necessity to obtain import permits as well as by administratively forced high customs declared values. The permits situation acts as a quantitative restriction, while the customs situation results in higher import duties. Imports of butter in 2011 are not expected to grow significantly, although the Government of Ukraine is considering some import policy relaxation to curb food price inflation.

Production:

Ukrainian dairy processors will continue to source milk from two major sources: industrial farms and private households. For the last 5 years or so the ratio between the two sources is almost unchanged and remains around 20:80, respectively (see Graph 1). It's nearly impossible for quality controls to be implemented and enforced at the household level. Consequently, milk procured from households is generally of low quality. Milk from private households must be pasteurized to be used in cheese or yogurt production due to bacterial insemination.

Graph 1. Trends in Ukrainian Milk Production



In 2007-2010, many dairy processors undertook expensive programs to establish their own industrial farms to insure quality milk supplies. These attempts have been partially successful, but have not been of significant magnitude due to high investment capital requirements. Milk from industrial farms remains the number one choice for dairy processors despite also encountering some quality problems. Processors often complain about milk contamination with bacteria and somatic cells. Also of concern are cases of tuberculosis in some farms.

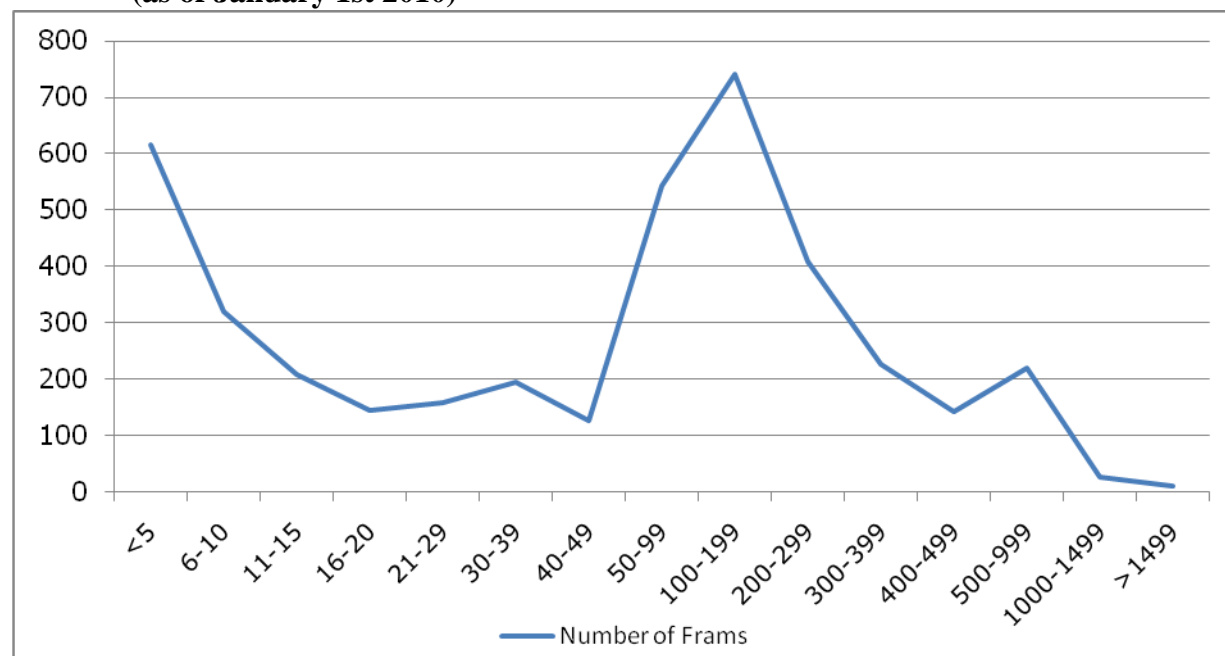
Table1. Production Indicators for Farms of all Types
Jan 1st – Aug. 1st (1000 MT)

Milk production	2009		2010		2010% to 2009
	Volume	Share	Volume	Share	
Farms of all types	8163.1	100	7871.8	100	96.4
Industrial Farms	1600.7	20	1578.2	20	98.6
Households	6562.4	80	6293.6	80	95.9

Source: State Statistic Committee of Ukraine

Industrial production of milk remains unspecialized. Many industrial farms view dairy enterprise as an auxiliary activity and keep dairy animals only to maintain a cash flow in winter months. A majority of industrial farms keep from 50 to 300 animals. Below is a distribution of animals in industrial farms that keep a dairy herd (4,093 farms out of approximately 22,000 industrial agricultural farms operating in the country).

Graph 2. Distribution of 4,093 Industrial Farms by Cow Number
(as of January 1st 2010)



The significant demand drop observed in 2009 and in 2010 did not lead to a significant milk price decrease. High quality milk remains in high demand by milk processors who are ready to pay premium

price for it. In early October a typical dairy in central Ukraine would be able to buy raw milk from industrial farms at UAH 3.50-4.0 (\$ 0.45-0.51) per 1 liter while private households would be able to get only UAH 2.50-3.0 (\$ 0.32-0.38). The difference in the price is due not only to lower quality of household milk but also due to additional expenditure of milk collection from households. Milk collecting trucks must visit multiple milk collection points. Additional cost is imposed on dairy processors by the milk production decrease. Milk-processing companies had to increase the area of collection to get the same amount of milk.

Production of milk in Ukraine remains highly seasonal with rather significant price fluctuations from month to month. Typically milk prices hit bottom in May –June. This year the lowest price for industrial farms reached UAH 2.5 (\$ 0.32) and for private households UAH 1.5 (\$ 0.19). High seasonality and significant shortages of raw milk in winter month influence Ukrainian processing facilities' production patterns. In Ukraine dried dairy products are produced only in spring and summer months.

The extremely hot summer of 2010 negatively impacted dairy yields, but had a limited impact on production of corn and other feed crops in Ukraine. No production limitation is expected from this factor. The dairy industry is not expected to experience any shortage, but the cost of feed will move up yet another step. Despite significant impacts of grain export slowdowns and restrictions imposed by the Ukrainian government in the middle of August, Ukrainian grain producers took note of the high world market price and have been reluctant to sell grains cheaply. Nevertheless, this action gave Ukrainian dairy producers some competitive advantage over their western competitors.

State support of dairy producers in 2010 remains very limited due to significant budget shortages. Limited direct support programs completely dried up in the second half of 2008. Ukraine is not expected to increase support in 2011 back to 2007-08 levels. Some limited indirect support continues from foregone budget revenue programs (zero percent Value Added Tax, or VAT), but these supports were never a decisive factor for the industry. In early 2010 even this limited support got interrupted due to political turmoil and delayed adoption of the state budget for 2010.

Development of Ukraine's dairy processors was significantly slowed by the financial crisis in 2008 and consequent reductions in sales in 2009-10. Previously many processors relied heavily on bank loans in their expansion programs. Now these companies rely on loan restructuring programs and seek out merger opportunities with financially stable competitors. The M&A market, slow in 2010, is expected to be more active in 2011.

In the 2009 dairy GAIN report it was indicated that Ukraine made another attempt to strengthen internal sanitary requirements for dairy products produced in households. Veterinary authorities planned to ban open-air market sales of fluid milk and soft cheese produced in households. These new requirements were supposed to become effective on January 1st 2010. If implemented, the requirements would reshape the domestic dairy market significantly since a significant share of milk from households is sold through open-air markets. Strong opposition against the new rules came from small business, regional state administrations and rural municipalities. As predicted in the report, the regulation was postponed until 2015.

The situation for 2011 is not clear due to macroeconomic developments that are beyond the scope of this report. The Ukrainian currency devaluation which continues to cause real incomes to drop, banking sector developments, world market situation as well as political developments in neighboring Russia – all these factors may impact Ukrainian dairy production in 2011. Production of products destined for the domestic market is likely to stabilize around 2009 numbers. Some redistribution of raw milk utilization will continue with growth of cheaper price segments and cheaper products. Production of cheese, yogurts and other whole milk products is expected to be relatively stable as demand stabilizes at a new post-crisis level. Production of dry milk products is expected to remain low due to raw milk shortage as well in response to low world market prices.

Consumption:

Ukraine is still in a deep recession, not yet recovered from the 2009 GDP decline of 15.0%. Analysts expect Ukraine's GDP may grow 3-4% in 2010, as demand for Ukraine's major exports, steel and chemicals is recovering. Low global demand for steel and chemical products, lack of credit, and problems in the Ukrainian financial sector are still troubling. Ukraine's new government has come to power during a severe economic crisis. The GOU's management of the crisis did not bring confidence in 2010. Ukraine has one of the riskiest sovereign ratings in the world and its banking sector is still unstable.

Overall consumption of dairy products (both produced in households and industrially) decreased in 2010 by 4-6%. Consumption of more expensive dairy products contracted significantly, while consumption in some cheaper segments grew. Market volume shrunk while market value grew around 11-17% in different segments. Consumers are accepting lower quality for higher price and are getting used to vegetable oils in traditionally dairy products. The demand for cheaper products is expected to continue throughout the rest of 2010 – 2011 and some market players may not survive the crisis.

Trade:

The situation on the import side is very tense. After some trade liberalization that followed Ukraine's WTO accession in May of 2008, the GOU started to revise trade rules in late 2008 which translated into rather significant import restrictions by the middle of 2009. Although technically import tariffs remained low and no new rules were officially introduced by controlling authorities, application of the existing rules got changed. Importers complain about restrictions imposed by two authorities: Ukraine's Custom Service (CS) and State Committee for Veterinary Medicine of Ukraine (SCVMU). According to importers the Customs Service assigns arbitrarily high import value for imported dairy products which results in increased associated import duty and Value Added Tax. In some cases new import valuation rules more than doubled import clearance price. In turn the SCVMU qualitatively limited imports using the import permit procedures. Due to unclear and controversial legislation the SCVMU demanded import permits for all imported products of animal origin including dairy. In many cases importers were denied import permits because of some technicalities or errors in application. In some cases import permits were delayed, so importers experienced additional losses in ports due to demurrage. The combined influence of both trade barriers eventually led to a considerable trade decrease. Imports of butter and dry milk products dropped to insignificant numbers (see PSD tables in Section II).

In a result of indirect import restrictions Ukrainian producer and surviving importers increased their prices contributing to high food price inflation in 2010. A shortage of raw milk and a raw milk price increase in August-September of 2010 also contributed to dairy product price growth. Concerned with the situation and facing approaching local elections the GOU reversed a bit by proposing to decrease import duties for selected dairy products. On October 14th 2010 the GOU has proposed a zero duty on the import of condensed milk, powdered and granulated cream, cream in other solid forms and butter until July 1, 2011. A relevant draft law was submitted and registered in Parliament on October 12. At present the import duty on condensed milk, powdered and granulated cream, cream in other solid forms and butter is 10%. This proposal will have market impact only in case of removal of the trade restrictions depicted above. Due to report requirements this proposal impact is not considered in PSDs.

Cheese

Due to disposable income drop consumption has shifted to cheaper varieties of unprocessed hard cheese, middle price processed and spreadable cheese. Some expert think that growth of cheap spreadable cheese segment happened at the expense not only hard cheese but butter, margarine and spread segments as well. Producers also used smaller packaging in response to demand shifts. This way producers were able to partially compensate the profit margin decline in production of hard cheese and meet increased costs. Producers also switched to other dairy products such as yogurts and whole dairy products.

The industry also found that by using non-dairy oils they could cut costs in products that had formerly been 100% dairy products. In previous years many companies positioned on the lower market segment were experimenting with palm oil in cheese products. Some consumer organizations and independent test centers reported non-dairy oil discoveries in cheap hard cheese. In 2010 this practice became widespread especially in price sensitive spreadable cheese segment. Outdated system of technical regulations allowed for marketing of this cheese product as regular cheese confusing consumers. None of industry players is ready to acknowledge the practice or initiate public discussion of this issue.

Despite a significant contraction of premium market segment imports of high quality cheese (mainly from EU countries) continued. Imported cheese remains significantly more expensive than domestic competitors at the top segment, but has by far superior quality. Imports of cheese are expected to continue in 2011, but no growth in this segment is forecasted. Consumers of imported cheese are affluent dwellers of big urban centers. Neither their number nor their incomes are expected to grow in the near future.

Due to a raw fluid milk shortage and somewhat weakened demand in the domestic market, production of cheese in 2009 was lower than forecasted. Supplies to a major export market in Russia are restricted and did not support production very much. At the same time attractive prices there make Ukrainian cheese producers target the Russian market as a priority over the domestic one. Despite trade barriers Ukrainian cheese makers continue to supply their products to Russia in 2009 while Russia regulates supply by listing or delisting Ukrainian producers. It is unknown if Russia will continue to audit Ukrainian dairy facilities. (Current the PS&D forecast is based only on currently existing exporters.)

All numbers in the PSD table were brought into compliance with official statistics. In 2010 production of cheese is not expected to change significantly mostly due to a lack of markets where more of low-end cheese can be sold. Shortage of raw milk will not have as significant impact on production as demand

drop. Cheese will remain a relatively high value-added product with good growth potential should consumers' incomes recover.

Butter

Production of butter in Ukraine in 2009 contracted as expected. This happened due to unavailability of cheap imports and high prices that created favorable conditions for the domestic producers. They were able to increase the price as soon as access for Belarusian butter on the Ukrainian market became limited due to high demand for Belorussian butter in Russia. Higher price improved butter attractiveness in comparison with expensive high-margin whole dairy products and cheese. The price increase during the summer months was unusual and very significant. In retail chains packaged butter grew by 32% from UAH 51.3 a kilogram (\$6.6) in July to UAH 67.8 (\$8.7) in early October causing consumption decrease. Given pretty inelastic consumption of this product in Ukraine such a big drop happened for the first time in last 5 years.

Consumers in Ukraine and abroad often complain about the quality of Ukrainian butter. Use of plant oils and some dairy byproducts in butter production brought Ukraine's producers a bad reputation. Lack of raw milk and low quality of the product makes return of Ukrainian butter to the Russian market unlikely despite a significant price premium that Ukrainian producers can earn there. Unlike cheese producers, Ukrainian butter makers cannot turn existing Free Trade Agreement between Ukraine and Russia in their favor.

Production of butter remains to be dependent on profitability of butter + NFDM combination. Increased attractiveness of butter production explains the increase in NFDM production in 2009. The extremely low NFDM prices through 2009 make the production of butter unattractive.

It is not clear whether existing trade restrictions would remain in place for the rest of 2010 and early 2011. In 2009 Ukraine became a first time ever importer of butter. Some unsatisfied domestic demand does exist and it is up to the GOU to establish clear import procedure for the potential exporters.

NFDM / WDM

Production of dry milk in Ukraine is a function of highly seasonal raw milk production and the industry's strong dependence on availability of this seasonal milk. Dry products have the lowest margin in comparison to other dairy products, face very small domestic market and suffer the most should raw fluid milk supply problem arise. In recent years Ukraine continues production of dried milk product despite general deficit of raw fluid milk on the market. The reason for that is simple: there is no other way to utilize cheap milk procured in summer months. Demand for whole milk products is price inelastic and rather stable throughout the year.

General decrease of raw milk available also decreases the availability of milk during seasonal peaks. Production of dried milk product in 2010 is expected to be smaller as producers look toward comparatively more attractive high-margin cheese and whole dairy products. Export of NFDM will contact as well. This should not come as surprise given the situation with butter. Production of WDM is expected to remain stable, but this product constitutes a quite small market segment.

The Ukrainian statistics service provides only 1 number for dry dairy products (NFDM, WDM and dry whey). Data in the PS&D for NFDM and WDM were obtained from consulting with companies, industry representatives and FAS/Kyiv's own market research.

A general production and export forecast for 2011 is negative due to a number of factors. Raw milk shortage and give little hope for production increases. Domestic demand for dried products is relatively stable and not expected to change much in 2011. Production of NFDM would remain to be less profitable than WDM due to the production of butter, which had no market outside of Ukraine. Both NFDM and WDM remain relatively low-margin products and long term production forecasts for these in Ukraine is negative. Facing a significant shortage of raw fluid milk, producers would prefer to utilize it in a more profitable manner.

Chapter II: Production, Supply and Demand Data Statistics:

Fluid Milk PSD Table*

Dairy, Milk, Fluid Ukraine	2009			2010			2011
	Market Year Begin: Jan 2009			Market Year Begin: Jan 2010			Market Year Begin: Jan 2011
	USDA Official	Old Post	New Post	USDA Official	Old Post	New Post	New Post
Cows In Milk	2,856	2,856	2,856	2,730	2,730	2,758	2,690
Cows Milk Production	11,300	11,300	11,370	10,961	10,961	10,950	10,570
Other Milk Production	240	240	240	240	240	242	242
Total Production	11,540	11,540	11,610	11,201	11,201	11,192	10,812
Other Imports	1	1	1	1	1	1	1
Total Imports	0	0	0	0	0	0	0

Total Supply	11,541	11,541	11,611	11,202	11,202	11,193	10,813
Other Exports	0	0	0	0	0	0	0
Total Exports	14	14	18	12	12	20	20
Fluid Use Dom. Consum.	3,527	3,527	3,483	3,120	3,120	3,290	3,170
Factory Use Consum.	7,050	7,050	7,090	7,150	7,150	6,920	6,693
Feed Use Dom. Consum.	950	950	1,020	920	920	963	930
Total Dom. Consumption	11,527	11,527	11,593	11,190	11,190	11,173	10,793
Total Distribution	11,541	11,541	11,611	11,202	11,202	11,193	10,813
CY Imp. from U.S.	0	0	0	0	0	0	0
CY. Exp. to U.S.	0	0	0	0	0	0	0

*These are not official USDA numbers

Cheese PSD Table*

Dairy, Cheese Ukraine	2009			2010			2011
	Market Year Begin: Jan 2009			Market Year Begin: Jan 2010			Market Year Begin: Jan 2011
	USDA Official	Old Post	New Post	USDA Official	Old Post	New Post	New Post
Beginning Stocks	0	0	0	0	0	0	0
Production	250	250	228	245	245	220	205
Other Imports	9	9	9	10	10	10	10
Total Imports	9	9	9	10	10	10	10
Total Supply	259	259	237	255	255	230	215
Other Exports	77	77	77	75	75	85	90
Total Exports	77	77	77	75	75	85	90
Human Dom. Consumption	182	182	160	180	180	144	125
Other Use, Losses	0	0	0	0	0	0	0
Total Dom. Consumption	182	182	160	180	180	145	125
Total Use	259	259	237	255	255	230	215
Ending Stocks	0	0	0	0	0	0	0
Total Distribution	259	259	237	255	255	230	215
CY Imp. from U.S.	0	0	0	0	0	0	0
CY. Exp. to U.S.	0	0	0	0	0	0	

*These are not official USDA numbers

Butter PSD Table*

Dairy, Butter Ukraine	2009			2010			2011
	Market Year Begin: Jan 2009			Market Year Begin: Jan 2010			Market Year Begin: Jan 2011
	USDA Official	Old Post	New Post	USDA Official	Old Post	New Post	New Post
Beginning Stocks	0	0	0	0	0	0	0
Production	72	72	75	70	70	76	72
Other Imports	18	18	16	20	20	3	5
Total Imports	18	18	16	20	20	3	5
Total Supply	90	90	91	90	90	79	77
Other Exports	1	1	1	0	0	1	1
Total Exports	1	1	1	0	0	1	1
Domestic Consumption	89	89	90	90	90	78	76
Total Use	90	90	91	90	90	79	77
Ending Stocks	0	0	0	0	0	0	0
Total Distribution	90	90	91	90	90	79	77
CY Imp. from U.S.	0	0	0	0	0	0	0
CY. Exp. to U.S.	0	0	0	0	0	0	0

*These are not official USDA numbers

Nonfat Dry Milk PSD Table*

Dairy, Milk, Nonfat Dry	Ukraine	2009	2010	2011
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	Market Year Begin: Jan 2009			Market Year Begin: Jan 2010			Market Year Begin: Jan 2011
	USDA Official	Old Post	New Post	USDA Official	Old Post	New Post	New Post
Beginning Stocks	2	2	2	2	2	2	2
Production	48	48	51	50	50	51	50
Other Imports	9	9	8	10	10	1	6
Total Imports	9	9	8	10	10	1	6
Total Supply	59	59	61	62	62	54	58
Other Exports	23	23	27	25	25	17	20
Total Exports	23	23	27	25	25	17	20
Human Dom. Consumption	34	34	32	35	35	35	36
Other Use, Losses	0	0	0	0	0	0	0
Total Dom. Consumption	34	34	32	35	35	35	36
Total Use	57	57	59	60	60	52	56
Ending Stocks	2	2	2	2	2	2	2
Total Distribution	59	59	61	62	62	54	58
CY Imp. from U.S.	0	0	0	0	0	0	0
CY. Exp. to U.S.	0	0	0	0	0	0	0

*These are not official USDA numbers

Dry Whole Milk Powder PSD Table*

Dairy, Dry Whole Milk Powder Ukraine	2009			2010			2011
	Market Year Begin: Jan 2009			Market Year Begin: Jan 2010			Market Year Begin: Jan 2011
	USDA Official	Old Post	New Post	USDA Official	Old Post	New Post	New Post
Beginning Stocks	0	0	0	0	0	0	0
Production	15	15	16	14	14	14	13
Other Imports	1	1	1	1	1	0	0
Total Imports	1	1	1	1	1	0	0
Total Supply	16	16	17	15	15	14	13
Other Exports	4	4	5	5	5	8	6
Total Exports	4	4	5	5	5	8	6
Human Dom. Consumption	12	12	12	10	10	6	7
Other Use, Losses	0	0	0	0	0	0	0
Total Dom. Consumption	12	12	12	10	10	6	7
Total Use	16	16	17	15	15	14	13
Ending Stocks	0	0	0	0	0	0	0
Total Distribution	16	16	17	15	15	14	13
CY Imp. from U.S.	0	0	0	0	0	0	0
CY. Exp. to U.S.	0	0	0	0	0	0	0

*These are not official USDA numbers